

# **Financial Reporting Advisory Board**

**Chairman: Elwyn Eilledge CBE**

Secretary:  
David Watkins  
HM Treasury  
1 Horse Guards Road  
SW1A 2HQ

Tel: 020 7270 4585  
Fax: 020 7270 4545  
Email: david.watkins@hm-treasury.x.gsi.gov.uk

## **From the Chairman**

D12, D13, D14 Comment letters  
International Accounting Standards Board  
30 Cannon Street  
London EC4M 6XH

May 2005

*Dear Sirs*

### **IFRIC DRAFT INTERPRETATIONS D12 TO D14**

The Financial Reporting Advisory Board (the Board) welcomes the opportunity to comment on the draft interpretations on service concessions issued by the International Financial Reporting Interpretations Committee (IFRIC). This letter summarises the Board's views and the annex provides more detailed comments about the draft Interpretations as a whole, and responds to the questions raised in draft Interpretations D12 to D14.

2. The Board welcomes IFRIC's contribution to the debate on accounting for service concessions, but believes that the draft Interpretations do not adequately address the problems faced by grantors and operators in determining the accounting treatment of, often, very complex transactions.

#### **Background to the Board and its interest in service concessions**

3. The Financial Reporting Advisory Board (the Board) acts as an independent element in the process of setting accounting standards for government. The Treasury is required by the Government Resources and Accounts Act 2000 to consult the Board on financial reporting principles and standards. The Board exists to promote the highest possible standards in financial reporting by government and to ensure that any adaptations of, or departures from, generally accepted accounting practice are justified and properly explained. The Board reports annually to Parliament about its activities and highlights areas of concern. More details about the work of the Board can be found on its website at [www.frab.gov.uk](http://www.frab.gov.uk).

4. The Board has concerns about the accounting treatment of projects financed through the Private Finance Initiative (PFI) and Public Private Partnerships and is, therefore, particularly interested in the three interpretations issued in draft by IFRIC. The

Board has raised with the Treasury the question of inconsistencies in the accounting treatment being adopted by the private and public sectors in individual projects. The Board has also noted that, while there is some consistency within individual types of project (for example, within the education sector, the health sector or the central government sector), there is no consistency across all sectors.

5. The Board's view is that one would normally expect symmetry in the accounting treatment by the two parties to a service concession – that is, that the assets appear on one balance sheet – not on both, nor on neither.

### **Summary of general concerns about the draft interpretations**

6. The Board acknowledges that IFRIC has had to react quickly to concerns about the lack of guidance on accounting for service concession arrangements. Despite the time pressures, however, the Board believes that it is important to consider simultaneously the accounting treatment by both operators and grantors. The current draft Interpretations are limited in scope to the operator, and this limitation is unlikely to assist in achieving symmetry in accounting treatment. The Board suggests that, should IFRIC feel unable to consider the grantor's accounting treatment, it might like to work with the International Public Sector Accounting Standards Board (IPSASB) with a view to the two bodies issuing guidance that will then cover both public and private sectors.

7. The Board has further concerns about the limits to the scope of the draft Interpretations. It believes that concession accounting should be sector-neutral, thus covering public-private, public-public, private-public and private-private arrangements. It appears to the Board that neutrality of the accounting guidance would help prevent the positioning of activities so as to achieve a desired accounting outcome – which is one of the criticisms of PFI accounting in the UK.

8. IFRIC has also limited the scope of the draft Interpretations by restricting them to infrastructure service concessions that involve public service obligations, where the infrastructure is kept available to the public. In the Board's view, this will exclude many of the UK's PFI projects from the scope of the draft Interpretations, since the concessions relate to infrastructure that do not meet these criteria. Although the term 'infrastructure' is defined in IAS 16, 'public service obligations' and 'kept available to the public' have not been defined; this lack of definition is likely to lead to inconsistencies in application.

9. Draft Interpretation D12 *Determining the accounting model* is based on a control approach taken from IAS 16. The Board believes that control is better determined in the light of an assessment of the extent to which each party bears the risks and rewards in the concession – that is, the draft Interpretations should be based around the concept in IAS 17 *Leases*. The IASB has used this concept in IAS 39, and IFRIC has also used it in determining a number of control criteria in SIC-12 *Consolidation- special purpose entities*.

10. The Board acknowledges that IFRIC needed some criterion to determine whether or not the operator's asset is financial or intangible. The Board is concerned that, by selecting the identity of the payer, PFI projects that are economically similar might be accounted for differently.

## Conclusion

11. The Financial Reporting Advisory Board has concerns about the consistency of the accounting treatment for PFI projects in the UK. It does not believe, however, that the proposals in the draft Interpretations will achieve the aim of providing guidance on how to account for service concessions because the Interpretations are severely limited in their scope in several ways. The Financial Reporting Advisory Board would also prefer to see Interpretations based on a consideration of the risks and rewards associated with the service concession arrangement (which could be by using the model of IAS 17 or by emphasising the importance of exposure to risk as evidence of control in the IAS 16 model), but whichever approach is adopted, the Board believes that the guidance needs to be applicable to all service concessions and to all parties to those concession arrangements.

*Yours faithfully*



pp **ELWYN EILLEDGE**

Approved by the Board on 9 May 2005 and signed in the Chairman's absence

## IFRIC DRAFT INTERPRETATIONS D12 TO D14: FINANCIAL REPORTING ADVISORY BOARD RESPONSE

### General comments on the draft Interpretations

1. Whilst welcoming IFRIC's contribution to the debate on accounting for service concession arrangements, the Board is disappointed that the proposals in draft interpretation D12 *Service concession arrangements – determining the accounting model* do not appear to be sufficient to address the inconsistencies in the accounting treatment of PFI projects in the UK. Thus the Board believes that the proposals, as drafted, will not meet the stated aim of providing guidance on how service concessions should be accounted for.
2. The scope of the draft Interpretation is severely limited: it applies only to the accounting by operators for public-to-private infrastructure service concessions (paragraph 4) that involve public service obligations (paragraph 5). Public service obligations are defined in paragraph 2 as arising under the "public policy [that the] services related to the infrastructure [are] to be kept available to the public, irrespective of the identity of the party that operates the assets". Paragraph 4 states that the Interpretation does not apply to public-private concessions that do not meet that condition. The Board notes that IFRIC refers to IAS 16 *Property, plant and equipment* in the Basis for Conclusions, referring to the IAS 16 definition of property, plant and equipment, which includes items held for use for administrative purposes. However, the Board believes that the drafting of the Interpretation itself, because it states that service concessions must deliver public service obligations, excludes assets held for use for administrative purposes.
3. The Board's view is that this will exclude, in the UK at least, several important PFI projects that typically involve the transfer of office accommodation and other estates (including, in the past, IT systems) to the private sector. These assets were never "kept available to the public" and so it is hard to see how this type of service concession can fall within the scope of the Interpretation. The Board also questions how prisons (listed in paragraph 1) could be considered as services kept available to the public in a strict interpretation of the phrase.
4. The Board infers from the draft Interpretation that this notion of public service obligations is seen as important. But the draft Interpretation is internally inconsistent in how it deals with it: for example the scope as set out in paragraph 5 states first that the service concession has to involve public service obligations, and then goes on to add two further conditions. In the Application Guidance in Appendix C, which is an integral part of the draft Interpretation, no mention is made of the need for a public service obligation. Instead, the scope is immediately stated as being the two further conditions as given in paragraph 5. Nor is this concept discussed in the Basis for Conclusions.
5. The scope of the draft Interpretation is also severely limited in the Board's view because it does not cover (a) service concessions where the partners are both in the private sector and (b) the accounting treatment that the grantor might be expected to adopt. Although there are inconsistencies in the application of the accounting guidance in the UK (FRS 5 *Reporting the substance of transactions* Application Note F *Private Finance Initiative and similar contracts*),

at least that accounting guidance covers both private and public sectors and can be applied to all types of PFI contracts. The limitations of the draft Interpretations are such that the Board does not believe they will improve accounting for PFI projects in the UK.

6. The Board believes that removing the artificial limitation to public-to-private arrangements and drafting an Interpretation in principled terms that could apply to any service concessions would lead to better accounting guidance with universal application. If, however, IFRIC feels unable to take that course, the Board suggests that IFRIC might like to work with the International Public Sector Accounting Standards Board (IPSASB) with a view to the two bodies issuing guidance that will then cover both operator and grantor alike from 2006.

### **Specific comments on D12 Service concession arrangements – determining the accounting model**

7. The Basis for Conclusions notes that the alternatives for recognition of an asset were either the control model based on IAS 16 or the risks and rewards model based on IAS 17 (*Leases*). As noted above, UK standard FRS 5 deals with accounting for the substance of transactions, and it is based around the risks and rewards model, thus mirroring what already existed in accounting for leases. The Basis for Conclusions refers to the complexities and inconsistencies in lease classification arising from the risks and rewards model, which could be difficult to apply to service concession arrangements, especially those in which users pay for the concession services or large elements of the payments are contingent on usage. The Board agrees that there are complexities in using the risks and rewards approach, but considers that the control model also brings its own difficulties.

8. Whilst agreeing that IAS 16 and IAS 17 present alternative models, the Board considers that the use of the control model would also entail a consideration of risks and rewards and that this ought to be highlighted in the Interpretations. The UK Accounting Standards Board's *Statement of Principles for financial reporting* states that one of the pieces of evidence that needs to be considered in determining control is exposure to risk – how and to what extent the investor suffers or gains from variability in the outcome.

9. The Board is strongly of the view that transactions should be accounted for in accordance with their substance and economic reality and not merely their legal form, in line with the IASB's *Framework* (paragraph 35). The Board is concerned that the specificity of the control conditions (despite the reference to the substance of the contractual arrangements in paragraph 13) in the draft Interpretation might lead to manipulation of the legal form thereby resulting in the assets being accounted for in a manner inconsistent with IFRIC's aims.

10. If one accepts that the accounting model for service concessions should be based on the concept of control, then there is an ineluctable logic that leads to the two models of financial assets and intangible assets as described in draft Interpretations D13 and D14. However, the Board is concerned that, by selecting the identity of the payer as the key criterion in determining whether the asset is financial or intangible, similar PFI projects could be accounted for differently.

11. For example, if the operator constructs a road and the grantor pays 'shadow' tolls then the operator has a financial asset. If the operator constructs a road and the public pay tolls to use the road, the operator has an intangible asset. In addition, once the operator has determined whether he has a financial or an intangible asset, then that asset has to be measured. Draft Interpretation D13 states that the financial asset should be measured

initially as the basis of the consideration received and thereafter at fair value. BC9 states that it is not expected that a service concession would ever be quoted in an active market, and that the asset should be classified as being available for sale, but the draft Interpretations do not state how the operator might estimate the fair value of a concession that could have a life of up to 30 years. IAS 39 states that assets that do not have a quoted market price in an active market and whose fair value cannot be reliably measured should be measured at cost, but D13 does not appear to envisage a situation where this type of financial asset could not be measured at fair value. Conversely, if the asset is intangible, draft Interpretation D14 states that, where its fair value cannot be measured reliably, then it should be measured at the fair value of the services provided by the operator, adjusted by the amount of any cash or cash equivalents transferred. Yet the economic substance of the two transactions is, with the exception of the identity of the payer, identical and the Board has misgivings that the accounting treatment should be so different.

### **D13 Service concession arrangements – the financial asset model**

12. The Board has no specific comments on draft Interpretation D13.

### **D14 Service concession arrangements – the intangible asset model**

13. The Board has considered the alternative approaches identified by IFRIC and agrees with the conclusion reached by the majority of IFRIC members (paragraph 10 of the Basis for Conclusions): that the operator receives the intangible asset in exchange for the construction services provided. The Board does not believe that the operator incurs expenditure to acquire the intangible asset. However, the Board also agrees with those IFRIC members who are uncomfortable (BC14) with the outcome of this treatment. It seems wrong for the operator to be able to record, in the example given in BC12, total revenues of CU305 compared with cash inflows of CU200.

14. BC13 suggests that such a result is not unique to service concessions, giving the example of goods and services given in exchange for another asset that is subsequently used to generate cash revenues. The Board questions whether that example is relevant to the consideration of a service concession. The substance of concession agreement is the provision of an infrastructure involving public service obligations where the infrastructure is kept available to the public (as it is under the financial asset model) : it is not two separate transactions.

15. The Board does not agree that IFRIC should remain silent on the timing of the recognition of the intangible asset. Of the three options presented in BC6, the Board believes that the conclusion that the operator receives the intangible asset in exchange for the construction services provided must mean that the intangible asset can be recognised only once construction is complete. It is only then that the operator has the right to future economic benefits and can reliably estimate the fair value of the intangible asset. This conclusion is supported, in the Board's view, by the balance sheet treatment in the illustrative example – as paragraph IE6 notes, the intangible asset is recognised at the end of year 2.

16. The Board agrees that the IFRIC has interpreted existing IFRS correctly in developing the different proposals for the accounting treatment of the operator's maintenance and repair obligations under the two models.